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Research Update:

Telekom Austria Downgraded To 'BBB-/A-3' On Increased Debt To EBITDA Following Spectrum Auction; Outlook Stable

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Overview

- On Oct. 21, 2013, Telekom Austria announced that it had acquired spectrum for €1.03 billion, which will increase its Standard & Poor's adjusted debt-to-EBITDA ratio by about 0.8x to roughly 3.6x at year-end 2013.
- We are consequently lowering our assessment of the group's financial risk profile to "significant" from "intermediate."
- We are also lowering our long- and short-term ratings on Telekom Austria to 'BBB-/A-3' from 'BBB/A-2'.
- The stable outlook reflects our expectation that the group's adjusted debt-to-EBITDA ratio will decline to less than 3.25x in the next 24 months, as a result of strengthening EBITDA generation on its improving competitive position and less intense competition in the Austrian mobile market.

Rating Action

On Oct. 23, 2013, Standard & Poor's Ratings Services lowered its long- and short-term corporate credit ratings on Austria-based telecommunications operator Telekom Austria AG to 'BBB-/A-3' from 'BBB/A-2'. The outlook is stable.

Rationale

The downgrade primarily reflects the marked deterioration of Telekom Austria's credit metrics as a result of its spectrum costs, which are substantially higher than we previously expected in our base-case scenario. We calculate that the group's Standard & Poor's adjusted debt-to-EBITDA ratio will increase by about 0.8x to roughly 3.6x at year-end 2013 as a result of its purchase of spectrum for €1.03 billion announced on Oct. 21, 2013. As a result, we have lowered our assessment of the group's financial risk profile to "significant" from "intermediate."

In our base case, we expect Telekom Austria's revenues to decline by about 4% in 2013, following a 2.8% decrease in 2012. Revenues should then be roughly stable revenues in 2014, with low-single-digit growth in 2015. In addition, we expect the group's EBITDA margin, as adjusted by Telekom Austria, to contract to about 31% in 2013 from 34% in 2012, but to improve gradually thereafter. We think the recovery will primarily be due to lower mobile market investments and less intense competition in Austria, as well as improving revenue trends at the group's international operations. The group acquired half of the total available spectrum of 2 x 140 MHz, including four blocks of 800 MHz spectrum, and no new mobile network operator acquired spectrum.

In our view, the group will likely improve its competitive position in the next few years thanks to the strong spectrum position, whereas the competitive position of its competitor, Hutchinson 3G Austria, is likely weakening. Still, we continue to assess Telekom Austria's business risk profile as satisfactory.

In our base case, we expect a gradual improvement of the group's debt to EBITDA to below 3.25x over the next 24 months. We mainly base this on our expectations of Telekom Austria's moderate free cash flow generation and improving EBITDA generation in the Austrian mobile market. We expect the group to generate about €300 million to €350 million in free operating cash flow annually in 2013-2015.

We continue to regard Telekom Austria as a government-related entity (GRE) under our criteria. The 'BBB-' rating on the group incorporates our assessment of its stand-alone credit profile (SACP) at 'bbb-'. In addition, the rating also factors in our expectation of a "low" likelihood of timely and sufficient extraordinary support, in the event of financial distress, from the group's 28.4% shareholder, the Republic of Austria (AA+/Stable/A-1+).

Liquidity

The short-term rating is 'A-3', reflecting the long-term rating of 'BBB-' on Telekom Austria and our assessment of the group's liquidity as "adequate" under our criteria.

Under our base case, we calculate that the ratio of liquidity sources to uses will exceed 1.2x in the 12 months from June 30, 2013. This assumes, however, that the group will refinance a meaningful portion of the spectrum costs in the next six months with additional debt.

As of June 30, 2013, liquidity sources mainly comprised:
- Surplus cash of about €0.9 billion;
- About €1.1 billion available under various committed credit facilities, of which €835 million mature after 2015;
- Positive funds from operations (FFO) of about €1.0 billion; and

As of June 30, 2013, liquidity uses included:
- Sizable debt maturities and modest deferred payments related to acquisitions, together totaling about €1.0 billion;
- Capital expenditures of about €0.7 billion and moderately negative working capital requirements;
- €1.0 billion in cash outflows related to spectrum investments in Austria; and
- Annual shareholder dividends (€22 million) and coupon payments on the group's hybrid bonds. We treat 50% of the annual coupon payment of €34

million as dividend payment and 50% as interest payment.

Outlook

The stable outlook reflects our expectation that Telekom Austria's debt-to-EBITDA ratio, as adjusted by Standard & Poor's, on stabilizing EBITDA in 2014 and modest EBITDA growth thereafter. We also expect an improvement of the ratio of adjusted FFO to debt to the mid-to-high twenty percent range in 2015, from about 23% at year-end 2013. Our expectation of gradually improving blended monthly mobile average revenues per user (ARPU) in Austria, from a low point of about €16 in 2013, will likely be the main factor fueling the strengthening in the group's credit metrics. This should follow recent market consolidation, the group's investments in high-value mobile customers, and its improving competitive position as a result of the spectrum acquisition.

We might consider a downgrade if Telekom Austria reports continued declines of group adjusted EBITDA beyond the low we expect in 2013, due to continued price competition on mobile ARPU, insufficient cost cuts, or continued EBITDA slippage at its international mobile operations. In addition, we could lower the rating if we think the group is unlikely to achieve the abovementioned improvement of its credit metrics by 2015.

Although unlikely in the next two years, we would consider an upgrade if we believe Telekom Austria could stabilize its revenues and improve its group adjusted EBITDA margin to more than 35%. A positive rating action would also likely depend on significant positive discretionary cash flow generation and a net debt-to-EBITDA ratio, after our adjustments, of less than 2.75x.

Related Criteria And Research

- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Telekom Austria AG Proposed Junior Subordinated Hybrid Securities Assigned 'BB+' Issue Rating, Jan. 21, 2013
- Key Credit Factors: Business And Financial Risks In The Global Telecommunication, Cable, And Satellite Broadcast Industry, Jan. 27, 2009

Ratings List

Downgraded

	To	From

Telekom Austria AG		
Corporate Credit Rating	BBB-/Stable/A-3	BBB/Stable/A-2
Junior Subordinated	BB	BB+
Telekom Finanzmanagement GmbH		
Senior Unsecured*	BBB-	BBB
Commercial Paper*	A-3	A-2

*Guaranteed by Telekom Austria AG.

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